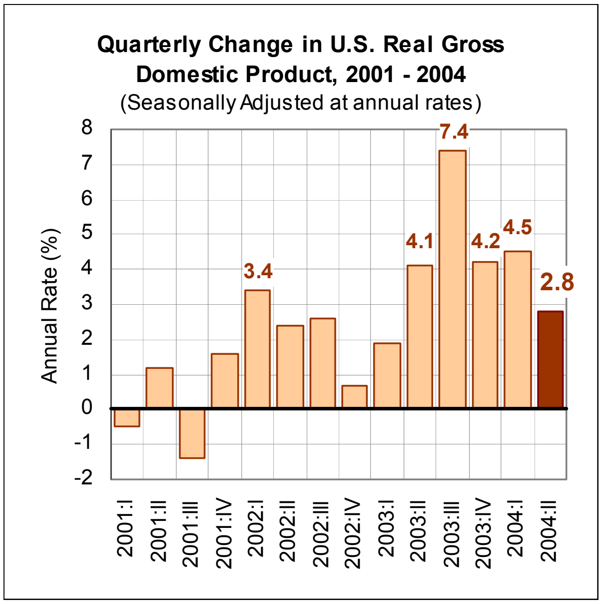
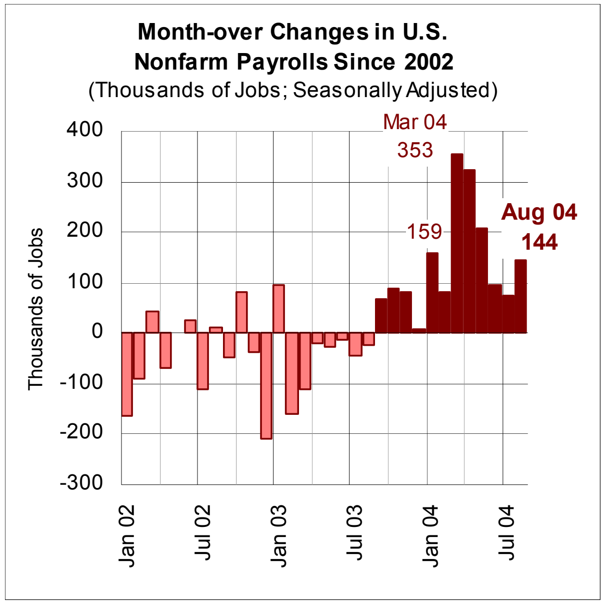
Economic Update

LMID Advisory Group Meeting
September 23, 2004

I. U.S. Economy

The U.S. economic recovery is nearly three years old, turning 33 months old in August 2004. However, in recent months the U.S. economy has been in what Alan Greenspan calls a "soft patch." As seen in the left hand chart below, real gross domestic product slowed to 2.8 percent in the second quarter of 2004, after growing at a healthy average annual pace of 5.1 percent over the previous four quarters (2nd quarter of 2003 through 1st quarter of 2004).





National job growth picked up noticeably during the past year. As seen in the right hand chart above, U.S. payrolls grew by 144,000 jobs in August, marking the 12th consecutive month of nonfarm payroll growth. When compared to the gains of 73,000 jobs and 96,000 jobs in July and June, respectively, the August numbers showed improvement but continued to lag behind the pace of job growth from March through May, when the U.S. economy grew by an average of 295,000 jobs per month. Moreover, most economists reckon that the U.S. economy needs to generate at least 150,000 jobs every month just to keep pace with the expanding labor force. This has happened just four times in the last 12 months.

Several other economic indicators have produced weaker results in the last two or three months than in previous months.

There is some ambiguity surrounding the strength U.S. economy and its future direction. While the consensus among economists is that the economy will continue to expand through the end of 2006 and beyond, there is less agreement over how strong it will grow. Most Wall Street economists, as well as Alan Greenspan, think the economy will strengthen during the remainder of this year, and then grow at a healthy pace of near 4.5 percent over the next two years. Optimists attribute the soft patch to “transitory factors” such as record high oil prices. Over the longer term, gas prices should fall, consumer spending will pick up, and business optimism will yield higher capital investment.

As is their wont, forecasters at the UCLA Anderson school are much more pessimistic, contending that the current “soft patch” in the economy will extend over the next two years. After growing at projected 4.3 percent pace in 2004, UCLA expects that GDP growth will slow to a more normal 3.3 percent pace in 2005 and 2006. Employment should grow at about the same pace as the labor force, or by slightly more than 150,000 jobs a month. This growth will not be strong enough to put much of a dent in employment.

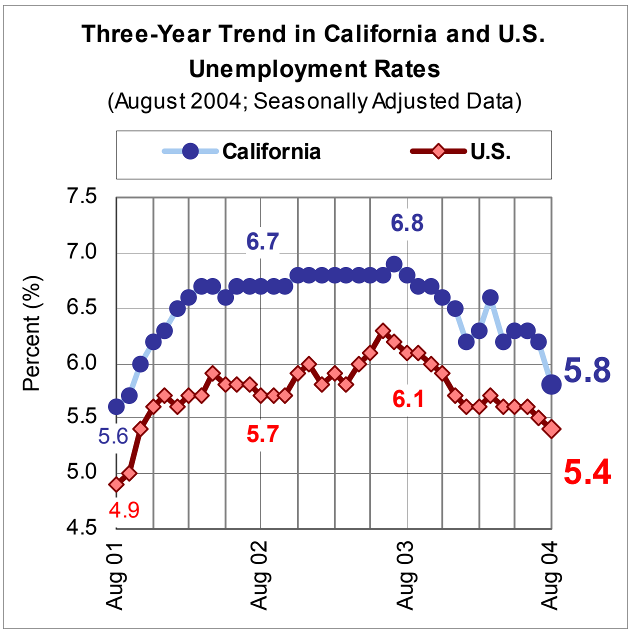
UCLA contends that it is unlikely that rising capital investment can produce faster economic growth because businesses must continue to work off their over investment in technology during the 1990s and investment tax incentives will expire at the end of the year. High debt will preclude government and consumers from boosting the economy. Consumer spending, stimulated by low interest rates and tax cuts, has propped up the economy in recent years. Now consumers are becoming tired and are increasingly “maxed out,” and the government’s stimulatory policies have run their course. Income growth typically boosts consumer spending, but has been weak, overall, and shows little sign of reviving in the slack labor market. Because the housing sector was immune to the recession, it will be unable to provide its traditional kick to the economy in the current recovery. Instead, the nation’s overheated housing sector may cool as interest rates rise. UCLA concludes that there is a greater likelihood of a consumer-led recession during the next two years than acceleration in economic growth. Others concur. While UCLA sees a 10 percent risk of recession in the next two years, the L.A. Times reports that Economy.com sees a 32.7 percent risk of recession in the next six months.

In contrast to the U.S., UCLA predicts “faster but not-yet-rapid growth” in California in 2005 and 2006. UCLA projects that nonfarm payrolls will grow by 0.8 percent in 2004, 2.0 percent in 2005, and 2.1 percent in 2006. The California economy should even be able to withstand a mild U.S. recession. Because the California economy has been growing more slowly than the U.S. economy, it has more slack to absorb recession than the national economy. Moreover, California’s most vulnerable industries have undertaken considerable restructuring after being particularly hard hit by the business cycle. But the State budget continues to be the fly in California’s ointment, particularly over the long term.

II. California Labor Force

Labor Force Employment

The seasonally adjusted California unemployment rate was 5.8 percent in August. This was the first time since September 2001 that the unemployment rate has been below 6.0 percent. As seen in the chart below, the California unemployment rate has been trending down during the last year, and has been largely tracking the U.S. unemployment rate.



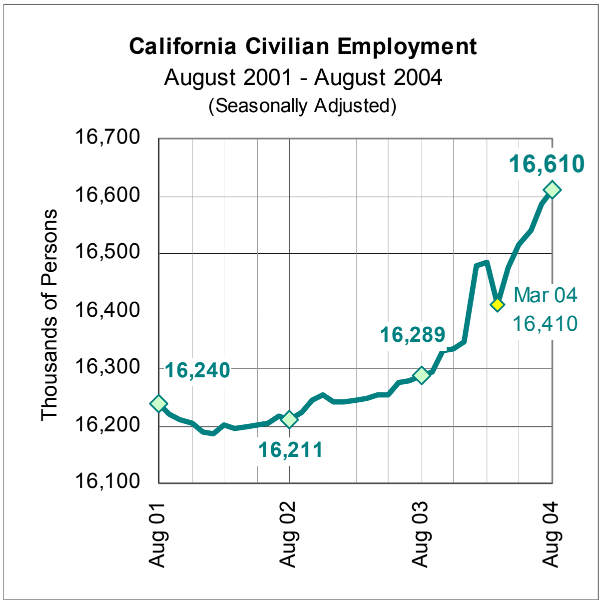
The U.S. unemployment rate fell 0.1 percentage point to 5.4 percent in August. This is the lowest the U.S. rate has been since October 2001. Year-over, the U.S. rate fell 0.7 percentage point.

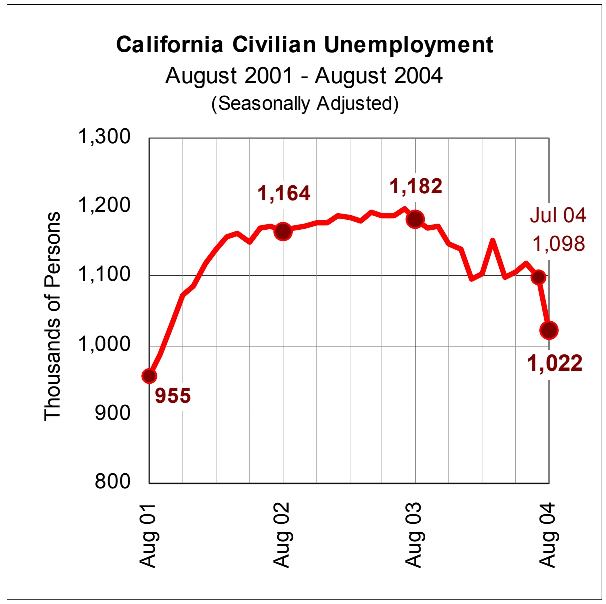
The gap between the California and U.S. rates was just 0.4 percentage point in August. This is the closest the California and U.S. rates have been since January 2001.

California's August labor force data were unusual in that there were unusually large drops in the unemployment and labor force participation rates, as well as extraordinarily large decreases in the number of unemployed and in the labor force. While this could be a statistical anomaly, there are probable economic explanations behind the unusual drops, also. August labor force data are often sensitive to the timing of the school year, and the movement of youth in and out of the labor force. The teenage unemployment rate stood at 20.2 percent in both July and August (12-month moving average), signaling that it was very difficult for many teenagers to find work this summer. Fall classes in many community colleges and some school districts began relatively early in August this year. This suggests that the large

August drops in the unemployment level, labor force, and participation rates reflect youth leaving the labor force to return to school.

The charts below show recent employment and unemployment trends. The number of employed Californians (left hand chart) increased by 23,000 persons to 16,610,000 in August. Over the last year, civilian employment in California has risen by 321,000 persons (or 2.0 percent). Civilian employment has grown by 200,000 persons (or 1.2 percent) over the last five months alone.

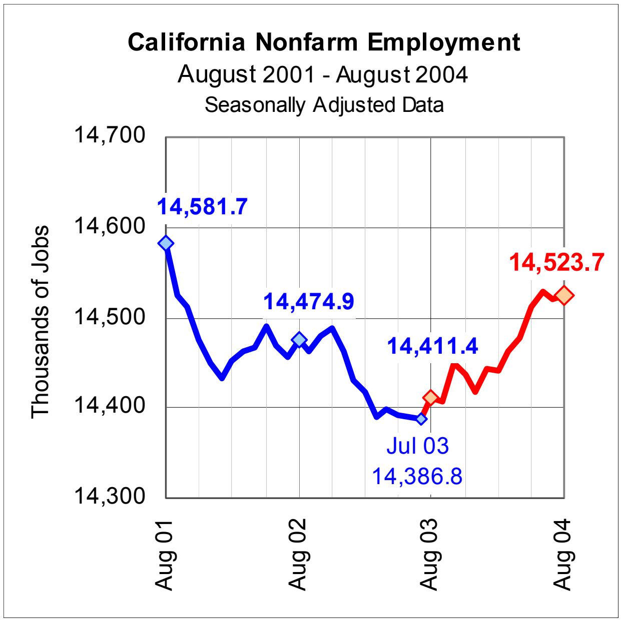




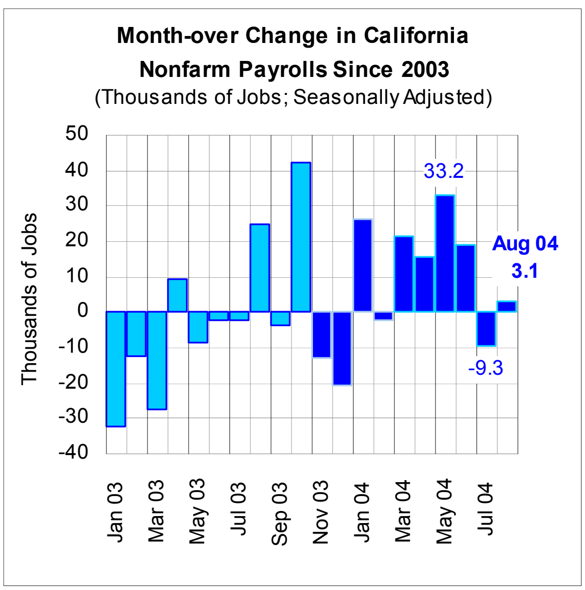
The number of unemployed Californians fell by 76,000 persons to 1,022,000 in August (right-hand chart). This followed a decrease of 20,000 persons in July. The August drop in the unemployment level was exceptionally large -- the largest one-month drop in a series dating back to January 1990. Year-over, the number of unemployed Californians decreased by 160,000 persons (or 13.5 percent). This compares to a 10.2 percent decrease in the national unemployment level.

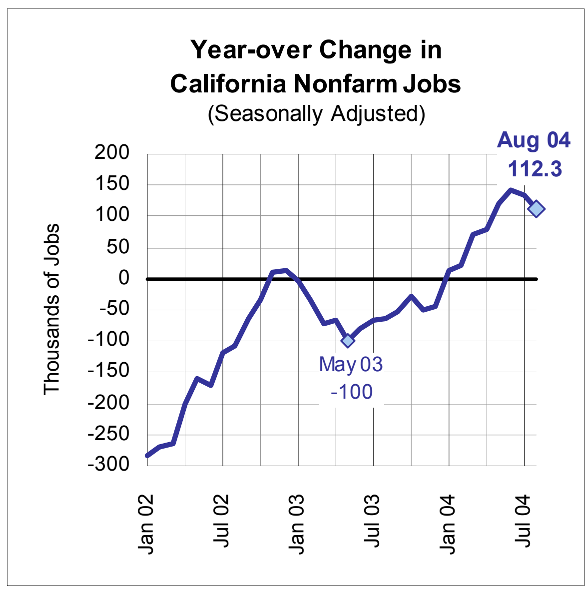
III. Nonfarm Employment

As seen in the chart at the top of the next page, there has been a distinct improvement in California's nonfarm employment growth over the last 13 months. The California economy added 136,900 jobs from July 2003 through August 2004, an increase of 1.0 percent.



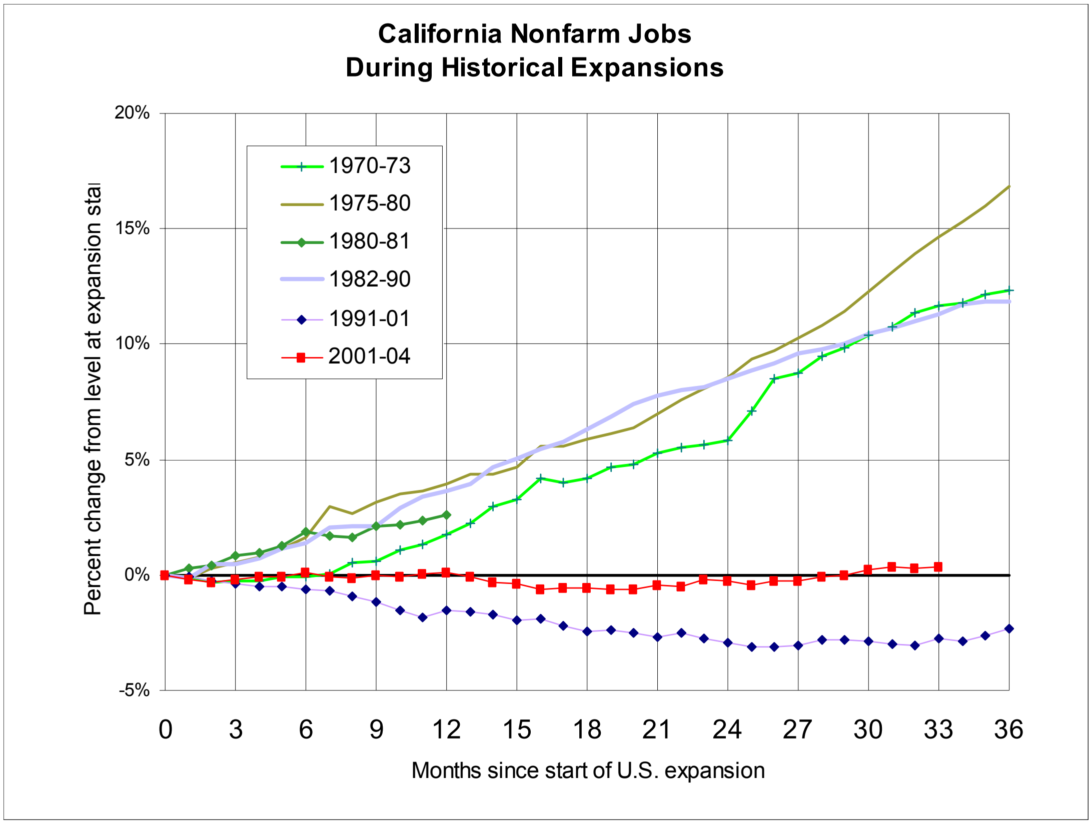
As seen in left hand chart below, August was the sixth month this year in which California gained jobs. Year-to-date, nonfarm job gains total 107,100 jobs (or 0.7 percent). However, there has been a pause in California's nonfarm payroll growth in the last two months. The State gained just 3,100 jobs in August, after losing 9,300 jobs in August. In comparison, nonfarm payrolls grew by an average of nearly 19,000 jobs a month from January through May of this year. In other words, both the California and U.S. and California economies have experienced something of a soft patch in recent months, at least when measured by job growth.

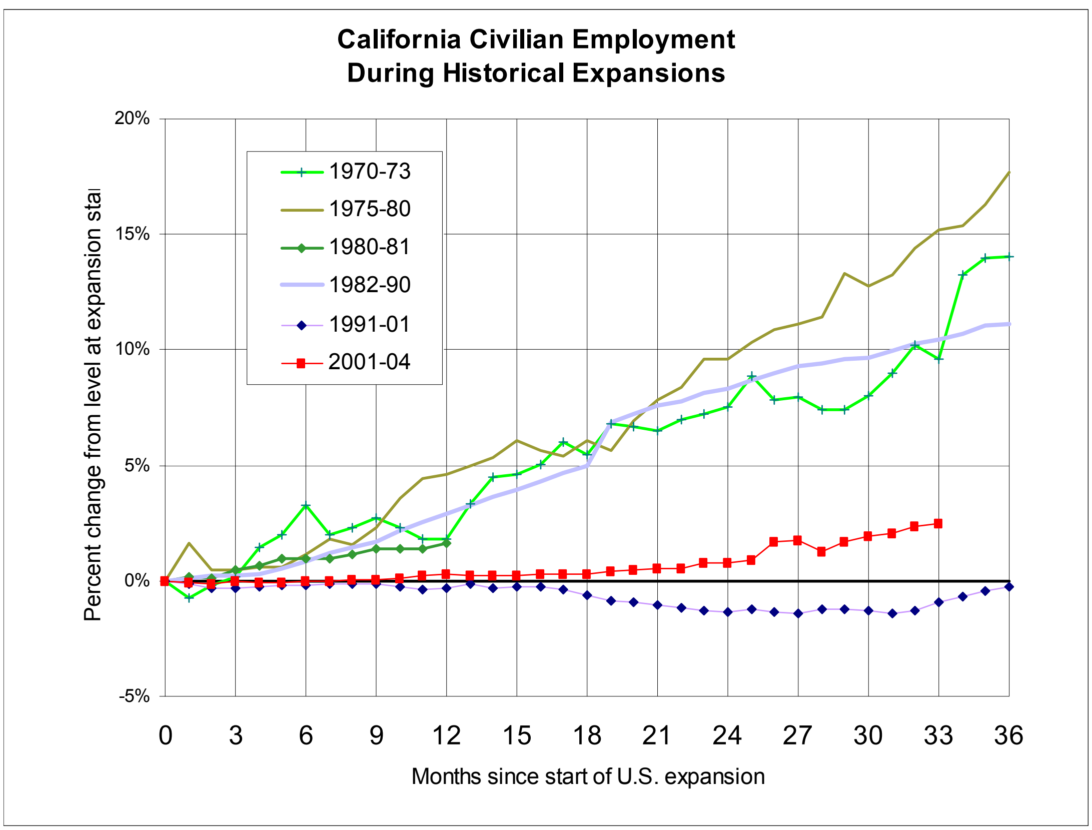




Comparisons of the year-over change in nonfarm employment (right hand chart above) provide a strong image of how the California economy has strengthened. California gained 112,300 jobs (an increase of 0.8 percent) over the last year. As recently as May 2003, California's year-over job losses totaled nearly 100,000 jobs (or 0.7 percent). At their peak in January 2002, California's year-over job losses totaled 282,600 jobs (or 1.9 percent).

With civilian employment growth in California and the nation outpacing nonfarm payroll growth, the debate over which measure of employment better captures the "true" state of the of the economy continues to percolate in the media. The charts on the following page compare the nonfarm job growth (top chart) and civilian employment growth (bottom chart) of the current economic expansion to the other expansions since 1970. The charts clearly show that in the current expansion to date, the pace of growth in both nonfarm employment and civilian employment has lagged behind the employment growth of every post-1970 economic expansion except the 1991 – 2001 expansion. Employment growth has been modest thus far in the current economic expansion when measured by either civilian or nonfarm employment. In other words, the cup is only half empty or full, but at least there is something in the cup.


California Nonfarm Jobs
During Historical Expansions
20%
15%
10%
5%
0%
-5%
Percent change from level at expansion sta
1970-73
1975-80
1980-81
1982-90
1991-01
2001-04
0
3
6
9
12
15
18
21
24
27
30
33
36
Months since start of U.S. expansion

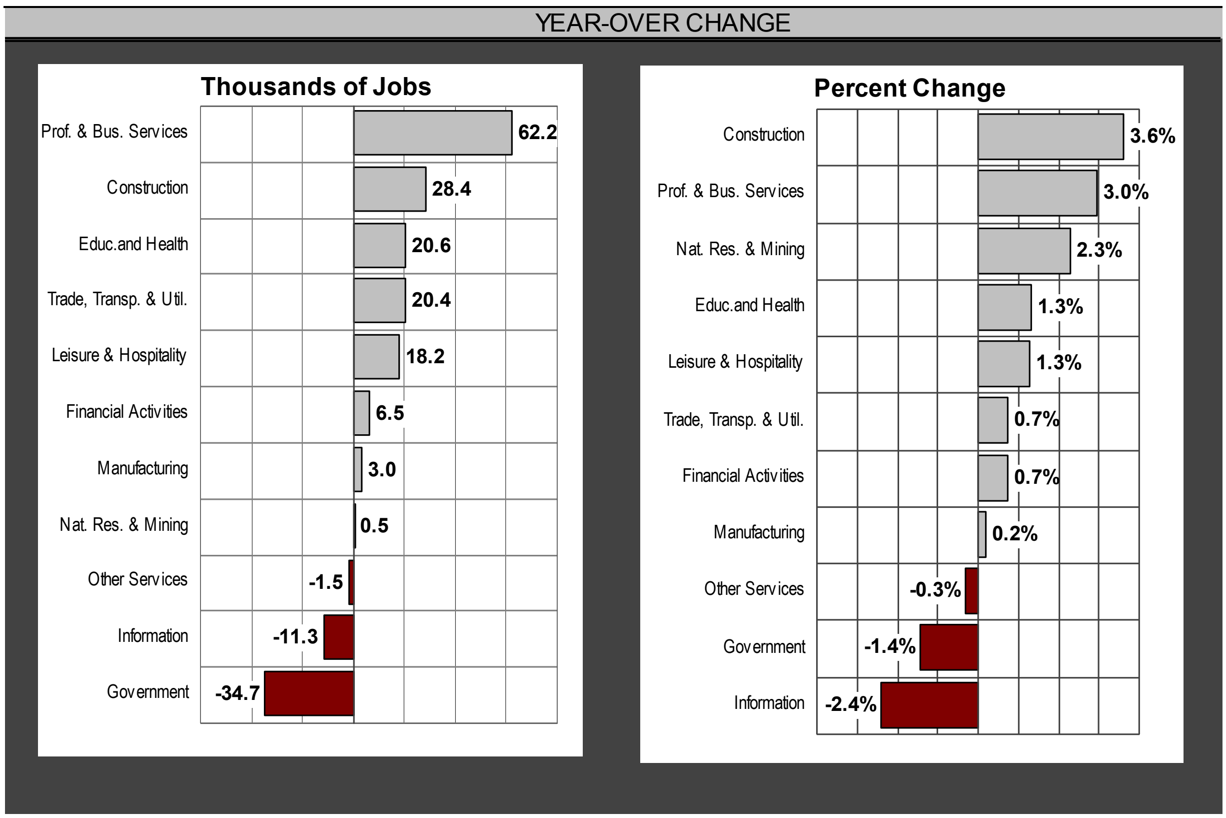

California Civilian Employment
During Historical Expansions
20%
15%
10%
5%
0%
-5%
Percent change from level at expansion sta
1970-73
1975-80
1980-81
1982-90
1991-01
2001-04
0
3
6
9
12
15
18
21
24
27
30
33
36
Months since start of U.S. expansion

IV. Industry Trends

The chart below shows year-over growth trends in California's major industry sectors.

Year-over Job Change in California Industry Sectors: August 2004

Seasonally Adjusted Data



Eight of California's 11 major sectors showed year-over job gains in August, while three showed losses.

Professional and business services, and construction showed the strongest job growth over the last 12 months. Professional and business services (up 62,200 jobs) added the largest number of jobs over the last year, followed by construction (up 28,400 jobs). Educational and health services; trade, transportation, and utilities; and leisure and hospitality have each contributed between 18,000 and 21,000 jobs over the last year.

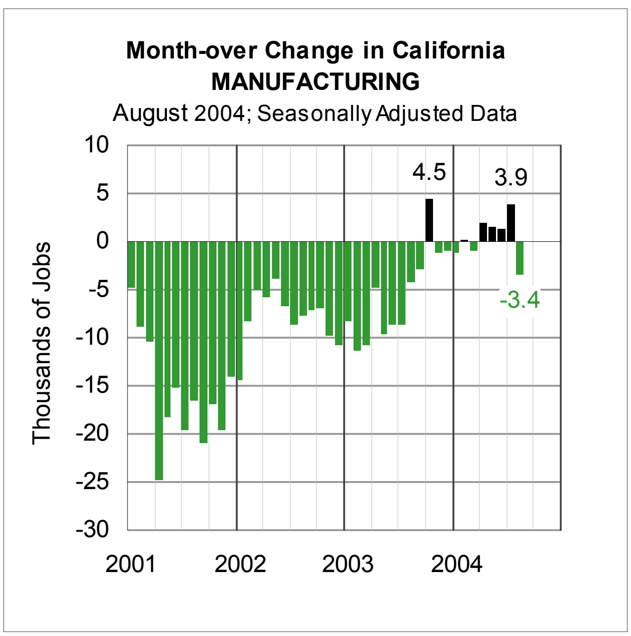
Construction (up 3.6 percent) grew at the fastest rate, followed by professional and business services (up 3.0 percent), and natural resources and mining (up 2.3

percent). Each of the remaining five gaining industries grew at a more modest pace over the last year -- 1.3 percent or less.

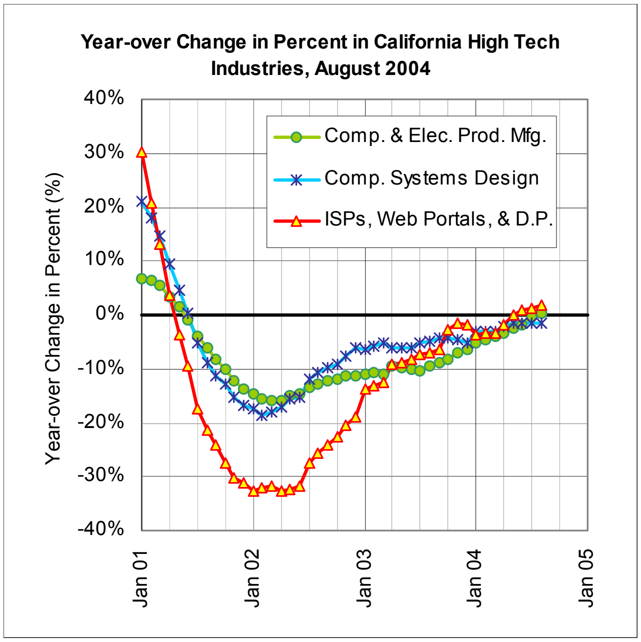
Government and information were the California economy's weakest industry sectors over the last year. Government (down 34,700 jobs) lost the largest number of jobs, followed by information (down 11,300 jobs). However, the deepest job losses were in information (down 2.4 percent), followed by government (down 1.4 percent). Other services was the only remaining industry sector to experience a net job loss over the last 12 months.

The most interesting industry employment stories relate to the turnaround in manufacturing and high technology industries.

The chart below shows month-over changes in manufacturing employment since the beginning of 2001. California manufacturing employment declined in 33 consecutive months from January 2001 through September 2003, with losses totaling 354,200 jobs (or 21 percent). However, California's manufacturing sector gained 5,800 jobs from October 2003 through August 2004. Despite losing 3,400 jobs in August due to less than normal hiring in the seasonal food manufacturing industry, manufacturing has gained 5,400 jobs over the last five months.



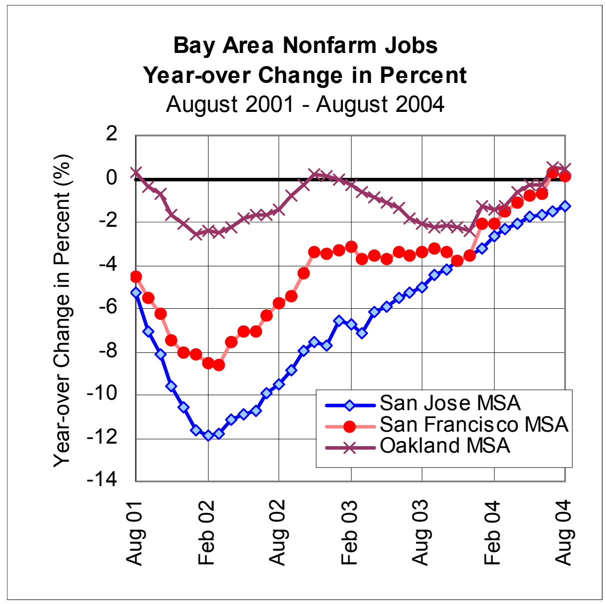
The chart at the top of the following page shows the trend in year-over employment in three key high technology industries that were very hard hit by the high technology bust cycle: computer and electronic product manufacturing; computer systems design and related services; and Internet service providers, web portals, and data processors. The data show that high technology employment has finally bottomed out and is poised to grow. Two of these industries – computer and electronic product manufacturing and Internet service providers – show year-over job gains, while the scale of year-over job losses in computer systems design is diminishing.



Over the year ending in August 2004, computer and electronic product manufacturing gained 700 jobs (an increase of 0.2 percent). This industry's year-over losses peaked in February 2002 at 69,500 jobs (or 15.7 percent). Internet service providers grew by 900 jobs (or 1.9 percent) over the year ending in August 2004. This compares to peak year-over losses totaling 28,100 jobs (or 32.7 percent) in January 2002. Computer systems design showed a year-over loss of 2,600 jobs (or 1.6 percent) in August 2004. This industry's year-over losses peaked at 40,500 jobs in February 2002 (a decline of 18.5 percent).

V. California Area Trends

Reflecting the turnaround in the high technology sector, employment in the Bay Area region has finally turned around, and employment in the region is poised for growth. The charts below show the trend in year-over job change in the 10-county Bay Area Region (left hand chart), and in its three largest areas: Oakland, San Francisco, and San Jose MSAs (right hand chart).



The table below shows that the San Jose MSA was the only one of the Bay Areas's six areas to experience a net job loss over the last 12 months.

Year-over Change in Nonfarm Employment in the Bay Area Region, August 2004

	Change in Number	Change in Percent
Bay Area Region	-3,700	-0.1
Santa Cruz MSA	900	1.0
Oakland MSA	4,700	0.5
Santa Rosa MSA	500	0.3
San Francisco MSA	800	0.1
Vallejo-Fairfield-Napa MSA	100	0.1
San Jose MSA	**-10,700**	**-1.3**